

RD AN No. 4216 (1980-D)  
September 26, 2006

TO: All State Directors  
Rural Development

ATTENTION: Rural Housing Program Directors,  
Guaranteed Rural Housing Coordinators,  
Rural Development Managers, and  
Area Directors

FROM: Russell T. Davis (*Signed by Russell T. Davis*)  
Administrator  
Housing and Community Facilities Programs

SUBJECT: Treatment of Applicant Collection Accounts  
Single Family Housing Guaranteed Loan Program

PURPOSE/INTENDED OUTCOME:

This Administrative Notice (AN) is intended to clarify RD Instruction 1980-D, section 1980.345(d) concerning collection accounts with outstanding balances. Specifically, this AN addresses whether it is required that the collection accounts with outstanding balances must be paid off prior to or at loan closing under the Single Family Housing Guaranteed Loan Program (SFHGLP). If the lender determines that there are mitigating circumstances under RD Instruction 1980-D, section 1980.345(d)(3), the participating lender's underwriter is responsible for deciding whether an applicant must pay off any collection accounts prior to or at settlement.

COMPARISON WITH PREVIOUS AN:

This AN replaces RD AN No. 4174 (1980-D) dated May 6, 2006, which is hereby retired. This AN differs from the previous AN in that it clarifies that aged collection accounts deemed by the lender as unnecessary to pay off do not necessarily represent an additional layer of risk.

EXPIRATION DATE:  
September 30, 2007

FILING INSTRUCTIONS:  
Preceding RD Instruction 1980-D

## BACKGROUND:

The National Office has received inquiries from both lenders and field staff on the question as to whether collection accounts must be paid in full prior to or at settlement.

RD Instruction 1980-D, section 1980.345(d)(1) states that an unacceptable credit history exists if the applicant's credit history contains any of the specified items, including the following:

- (vi) Accounts which have been converted to collections within the last 12 months or
- (vii) Collection accounts outstanding, with no satisfactory arrangements for payments, no matter what their age as long as they are currently delinquent and/or due and payable.

RD Instruction 1980-D, section 1980.345(d)(3) permits a lender to consider mitigating circumstances to establish the applicant's intent for good credit. In such cases the lender and borrower must document that the circumstances surrounding the derogatory credit were of a temporary nature, and beyond the applicant's control, and have been removed. Alternately, the lender and borrower must document that the adverse action or delinquency was the result of a refusal to make full payment because of defective goods or services, or as a result of some other justifiable dispute relating to the goods or services purchased or contracted for.

Based on the regulation, paying an outstanding collection account is not justification, in itself, that would establish an applicant has demonstrated a willingness to meet obligations in an acceptable manner. Payment of the collection account may cause the depletion of cash resources that could otherwise be available as reserves or for closing costs. The lender's underwriter is required to determine the prospects of the applicant repaying the loan to be guaranteed by the Agency. If the lender establishes there were mitigating circumstances to adverse credit in accordance with section 1980.345(d)(3), the underwriter may determine that it is not necessary to pay a collection account in order to establish the applicant's creditworthiness.

## IMPLEMENTATION RESPONSIBILITIES:

Applicants are expected to demonstrate a reasonable ability and willingness to meet obligations as they come due. If a lender has established that there are mitigating circumstances concerning an applicant's credit history as described in RD Instruction 1980-D, section 1980.345(d)(3), the lender is responsible to determine what collection accounts, if any, should be paid in full by the borrower prior to or at loan closing. Mitigating circumstances must be documented in the file. The lender should document the determination on the underwriting transmittal. If the applicant has a representative credit score of 660 or higher, and the co-applicants, if any, have representative credit scores not lower than 620, further documentation by the lender is not required.

We emphasize that the loan, while guaranteed by the Agency, is the lender's loan. Unpaid collection accounts aged greater than 12 months do not necessarily represent an additional risk layer when considering debt to income ratio exceptions. Indeed, paying off the collection

account may give rise to greater risk in that doing so may reduce funds set aside for emergencies, or deplete funds which could have gone toward closing costs and reduced the need to borrow. Whether the collection account represents a greater risk or must be paid off is entirely the lender's decision, regardless of the credit score.

In addition, we recognize that collection accounts do not automatically become judgments or liens against real estate without the creditor taking several additional legal steps at significant additional expense. Reporting an account as a collection account is never an automatic lien or judgment in favor of the creditor. For any collection account to become a lien, the creditor must first file a lawsuit and obtain a judgment. The creditor must then file with the court to execute the judgment. Once the lender has perfected a first lien as required by RD Instruction 1980-D, section 1980.331(a), any lien that might arise from a creditor suing to convert a collection account into an executable judgment would never take priority over the lender's first lien. In the case of aged collection accounts, it is less likely that legal action will take place because the creditor may have already concluded that further legal action was not cost effective. Regardless, it is at the lender's discretion whether any collection account is an additional layer of risk and must be paid off.

Any questions about this AN should be directed to Joaquín Tremols or Dave Chaput of the Single Family Housing Guaranteed Loan Division at (202) 720-1452. Their respective email addresses are [joaquin.tremols@wdc.usda.gov](mailto:joaquin.tremols@wdc.usda.gov) and [david.chaput@wdc.usda.gov](mailto:david.chaput@wdc.usda.gov).